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Picking Winners Again: Government tinkering in the tech sector



Picking Winners Again: Government Tinkering in the Tech Sector

This is one in a series of Occasional Papers published by the UKIP Parliamentary Resource Unit (UKIP PRU). It is written to support the work of the UKIP Parliamentary party and to contribute to policy debate and development. Views expressed do not necessarily reflect those of Douglas Carswell MP or the policy of UKIP.

Summary

The Government has placed its faith in the digital economy to boost Britain's long-term growth. *Tech Nation 2016*, a report on the dynamism of Britain's high-tech start-ups by the quango Tech City UK, celebrates a digital sector with annual turnover of £161 billion, growing a third faster than the rest of the economy.^{1 2}

However, high-tech's apparent success may not be all it seems. The majority of start-ups fail. Analysts have warned that the rate of the annual growth in UK tech investment – 41% in 2014 – is unsustainable.³
^{4 5} There is a danger that the technology sector is a precarious bubble.

The enormous expansion of British start-ups is largely the result, not of customer demand, but of an extremely liquid investment market – much of which derives from public subsidy. The Government's preference for niche ventures, specifically in start-ups, has distorted investment, especially into the British technology sector. Badly directed taxpayer funds, along with lax monetary policy has saturated the early-stage funding markets, potentially starving more viable (if less fashionable) businesses of finance, and gambling huge amounts of money on high-risk, unproven enterprises.

Contributing to a start-up bubble harms taxpayers, investors, innovators, and consumers. A better way for the Government to cultivate the British answer to Silicon Valley is to simply get out of the way, and allow business and investment to grow of its own accord.

1. Inflating the tech bubble

In the last few years, the number of start-ups in the UK has skyrocketed, especially in the technology sector. The Government's *Tech Nation* publication identified 58,000 active digital businesses in early 2016 and put employment growth in the sector 2.8 times higher than in the rest of the economy.⁶ The average advertised salary in those jobs is also claimed to be around £50,000, significantly higher than the UK average.⁷

However, the sustainability of this tech boom is questionable. The expansion in the sector has primarily been driven by capital, not sales – and the former often fails to lead to the latter. In 2014, the RSA Insurance Group surveyed UK SMEs and concluded that 50% of all start-ups will fold within the first five years of their existence.⁸ In Britain's technology sector especially, there is a risk that output will fall short of the input. As *Moneyweek*'s Matthew Lynn puts it, "there is an avalanche of cash that is now chasing very few genuinely profitable opportunities".⁹

¹ Tech City UK, *Tech Nation: Transforming UK Industries*, accessed 16/05/2016 at: <http://www.techcityuk.com/wp-content/uploads/2016/02/Tech-Nation-2016_FINAL-ONLINE-1.pdf>

² Ibid.

³ "Is the UK experiencing a tech startup bubble?" Smithfield Business Centre, 28 December 2014, accessed 16/05/2016 at: <<http://www.smithfield.co.uk/#!/is-the-UK-experiencing-a-tech-startup-bubble/c1fjq/069E17C5-C30F-4734-ACDA-52A39D6DCA41>>

⁴ Ibid.

⁵ J. Titcomb and B. Martin, "UK companies succumb to tech bubble fears", *Daily Telegraph*, 7 Apr 2014 accessed 16/05/2016 at: <<http://www.telegraph.co.uk/finance/markets/10749492/UK-companies-succumb-to-tech-bubble-fears.html>>

⁶ Tech City UK, *Tech Nation: Transforming UK Industries*, accessed 16/05/2016 at: <http://www.techcityuk.com/wp-content/uploads/2016/02/Tech-Nation-2016_FINAL-ONLINE-1.pdf>

⁷ Ibid.

⁸ RSA Group, *Growing Pains: How the UK became a nation of "micropreneurs"*, October 2014, accessed 16/05/2016 at: <<http://www.rsabroker.com/system/files/SME%20Growing%20Pains%20White%20paper.pdf>> page 9

⁹ M. Lynn, "Too much money is pouring into tech funds", *Moneyweek* (22/10/16): <<http://moneyweek.com/too-much-money-is-pouring-into-tech-funds/>>

Just as dotcoms proved to be a bubble in the late 1990s, the high-tech sector may be inflated again today. Around the world, there are fears that many start-ups have been overvalued. So-called “unicorn” firms – those nominally worth over \$1 billion – are increasingly discovering that their real market value is much lower in later funding rounds and IPOs.¹⁰ In the UK, crowdfunded investment is a particular concern. A recent study of 115 companies seeking crowdfunding investment revealed that 90% were either unprofitable or had no trading history.¹¹

Although much of this investment originates in the private sector, the digital economy is also heavily supported by the state. A combination of tax breaks, matched funding schemes, and direct subsidies has provided substantial capital for start-ups – many of which prove unable to scale up. As such, the government is investing heavily in many companies that will never become independently viable, contributing to the overvaluation of the sector in the process.

Government-funded schemes include the following:

- **Innovate UK**

A quango whose stated objective is to link research (mainly universities) with business to encourage economic growth.¹² This is achieved via a series of funding competitions and research and development grants. One of its aims is to “determine which science and technology developments will drive future economic growth” – implying a conscious command-and-control choice on the Government’s part.¹³ Innovate UK has been awarded extra funding from the additional £4.7 billion allocated to research and development over the next five years, announced in the 2016 Autumn Statement.¹⁴

- **Angel Co-Fund**

Capitalised with £100 million from the Regional Growth Fund and the (state-owned) British Business Bank, the Angel Co-Fund invests in small businesses alongside syndicates of business angels, making initial equity investments of between £100,000 and £1 million in small businesses. Since its launch in 2011, it has invested £31 million, alongside a further £138 million from private investors.^{15 16 17}

- **Enterprise Investment Scheme (EIS) & Seed Enterprise Investment Scheme (SEIS)**

Both EIS and SEIS offer tax breaks to individual investors. Launched in 2012, SEIS offers 50% income-tax relief for investors in very early-stage start-ups, defined as companies with fewer than 25 full-time staff and gross assets of below £200,000.¹⁸ Individuals may claim tax relief on a maximum annual investment of £100,000, while a company may raise no more than £150,000 via SEIS annually.¹⁹

Set up in 1994 and expanded by successive governments since, EIS provides 30% tax relief for investors in later-stage companies. To qualify, a company must have fewer than 250 full-time staff and no more

¹⁰ See e.g. J. Titcomb, “Don’t look down: Tech unicorns face reckoning as valuations detach from reality”, *Telegraph* (7/11/15).

¹¹ G. Robins, “Why equity crowdfunding platforms must take due diligence more seriously”, *City AM* (10/3/16).

¹² HM Government, Innovate UK, About Innovate UK, accessed 16/05/2016 at: <<https://innovateuk.blog.gov.uk/about-innovate-uk/>>

¹³ HM Government, Innovate UK, About Us, accessed 16/05/2016 at: <<https://www.gov.uk/government/organisations/innovate-uk/about>>

¹⁴ Rt. Hon. Phillip Hammond MP, *Autumn Statement 2016*, HM Treasury, p.16.

¹⁵ Angel Co-Fund, About Us, accessed 16/05/2016 at: <<http://www.angelcofund.co.uk/about>>

¹⁶ “Angel Co-Fund”, British Business Bank: <<http://british-business-bank.co.uk/ourpartners/angel-cofund/>>

¹⁷ “£100 million fund to support business growth goes national”, HM Government (3/7/13): <<https://www.gov.uk/government/news/100-million-fund-to-support-business-growth-goes-national>>

¹⁸ HM Government, Seed Enterprise Investment Scheme: how companies qualify, 22 October 2013, accessed 16/05/2016 at: <<https://www.gov.uk/guidance/seed-enterprise-investment-scheme-how-companies-qualify>>

¹⁹ Seed Enterprise Investment Scheme, accessed 16/05/2016 at: <<http://www.seis.co.uk/>>

than £15 million in gross assets. Individuals may claim tax relief on a maximum annual investment of £1 million, while companies may not raise more than £5 million via EIS per year.^{20 21}

EIS and SEIS have particularly stimulated investment in equity crowdfunding. The Financial Conduct Authority (FCA), which regulates investment in crowdfunding, records that equity crowdfunding grew by 201% in 2014, and that “almost 95% of the funded deals were eligible for the Enterprise Investment Scheme (EIS) or Seed EIS (SEIS) schemes”.²² The British Business Bank notes that crowdfunding platforms not only promote the tax incentives available via these schemes, but, in some cases, only host companies that are eligible for EIS or SEIS funding.²³

- **The Start Up Loans Company**

Established in 2012 and supported by the British Business Bank, the Start Up Loans Company offers any individual over the age of 18 a loan of up to £25,000 to start their own business, as well as free mentoring and advice. Start Up Loans are government-backed, charging a fixed annual interest rate of 6%, and distributed via a network of 30 local organisations that act as delivery partners to the Company. As of October 2016, the Company had lent £260 million to nearly 43,000 businesses.^{24 25 26}

- **Regional Growth Fund**

The Regional Growth Fund (RGF) was established in 2010 to provide grants to private-sector projects with (presumed) growth potential, and to boost private enterprise in those local areas most dependent on public-sector employment.²⁷ It has invested £2.6 billion thus far, though no further funding rounds are planned.²⁸ Some of this capital has been targeted at technology start-ups, notably via Local Enterprise Partnerships.²⁹ Both the National Audit Office and the House of Commons Public Accounts Committee have questioned the efficacy of the RGF, arguing that it delivered inadequate value for money for taxpayers.³⁰

2. Picking winners again: Tech City UK

As well as subsidising the tech sector more broadly, the Government also provides benefits in kind to a select group of companies, via its technology quango, Tech City UK. Overseen by a board of venture capitalists and technology professionals and funded by the Department of Culture, Media & Sport, Tech City UK aims to accelerate the growth of the digital economy both in London and across the UK.³¹ To that end, it runs numerous schemes that effectively give special assistance to a select group of qualifying UK businesses.³² These include:

- **Future Fifty**, which provides a select group of fifty late-stage tech companies access to contacts in UK Government, promotion, networking opportunities, and advice from industry experts.

²⁰ “Enterprise Investment Scheme”, HMRC (7/10/13).

²¹ “Enterprise Investment and Seed Enterprise Investment Schemes: Introduction to National Statistics”, HM Government.

²² “A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media”, FCA (02/2015).

²³ “Equity Crowdfunding in the UK: Evidence from the Equity Tracker”, British Business Bank (03/2014), p.6.

²⁴ “Start Up Loans”, HM Government: <<https://www.gov.uk/start-up-loans>>

²⁵ “About the Start Up Loans Company”, Start Up Loans: <<https://www.startuploans.co.uk/about-start-up-loans-company/>>

²⁶ “Our Delivery Partners”, Start Up Loans: <<https://www.startuploans.co.uk/delivery-partners/>>

²⁷ *Regional Growth Fund Annual Monitoring Report 2014/15*, HM Government, p.2.

²⁸ “Guidance: Regional Growth Fund”, HM Government (4/12/15).

²⁹ *Regional Growth Fund Annual Monitoring Report 2014*, HM Government, p.28.

³⁰ M. Ward, *Regional Growth Fund*, House of Commons Library (02/11/16), pp. 14-16

³¹ Tech City UK, About Us, accessed 16/05/2016at: <<http://www.techcityuk.com/about-us/>>

³² Ibid.

- **Upscale**, which offers thirty fast-growing companies mentorship from “Scale Coaches” (individuals who have built successful digital companies)
- **Digital Business Academy**, a taxpayer-funded online platform providing free access to digital business skills and networking opportunities.

Selecting certain firms for special treatment has a bad pedigree. Tech City UK has echoes of Harold Wilson’s Ministry of Technology set up in 1964. Just as Wilson attempted to align his own premiership with new technology in the mid-twentieth century, Tech City UK seeks to associate the state with the currently fashionable idea of people starting businesses from their bedrooms. And just as the Ministry of Technology never turned Britain into a modern industrial powerhouse, there is little reason to believe that Tech City UK will create a flourishing digital economy.

Picking winners rarely delivers sustainable industry. Just as a mass market for smart phones and online on-demand television was unimaginable fifty years ago, so future technological trends are likely to be impossible to forecast. Too often, attempts to do so favour the trends of today, thereby hindering, rather than advancing, technological progress.

3. Favouritism can’t beat the market

Huge intellectual effort has been expended by commentators asking why it is that Britain or at least Europe seems to have no answer to American technology giants like Amazon and Google. Few seem to point out that the growth of Silicon Valley’s superstars was organic, not the result of government sponsorship.

The attempt to compete with American innovation through the brute force of government policy has already been tried in Europe – with little success. France, initially with German support, attempted to create a European rival to Google, to be called Quaero. Despite receiving a €99 million development subsidy from the French government (approved by the European Commission), the project never took off, finally folding in 2013, five years after its launch.³³

Although the British Government’s approach has been less heavy-handed, its involvement in the technology sector is no more likely to create a “British Google”. The original internet giants were borne of the free market. They were fiercely competitive and uniquely creative business ventures that attracted customers not through tilted tax regimes or official favouritism, but because they disrupted traditional markets and offered a service that consumers wanted. Far from energising the digital economy, the Government is pumping too much capital into the technology sector, distorting the real values of companies, and potentially diverting investment away from other areas of the economy that might be more profitable and sustainable.

The Government would provide a better service to taxpayers and small companies by halting its current spending schemes, prioritising tax cuts over preferential tax breaks, and allowing the market to determine the risks and rewards of investing in new businesses.

³³ See “In search of a European Google”, *Observer* (6/12/15): < <https://www.theguardian.com/technology/2015/dec/06/europe-google-silicon-valley-digital-industry>>